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IN THE

SUPREME COURT
OF THE
UNITED STATES.

October Term, 1937
No. 387.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

BANKLINE OIL COMPANY, a corporation,
Respondent.

BRIEF FOR RESPONDENT.

A. L. WEIL,
1003 Higgins Bldg., Los Angeles, Cal.,
Counsel for Respondent.

MARTIN J. WEIL,
Of Counsel.

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BRIEF FOR RESPONDENT.

Restatement of Question Presented.

The sole question for the determination of this Court is whether respondent, by virtue of the contracts which it entered into, and by which it acquired the right to all of the gas produced from certain oil and gas wells, acquired an economic interest in the gas produced from those wells, upon which it is entitled to an allowance for depletion.

Statement of the Case.

Starting in the year 1922 and during the three years in question, to-wit, 1927, 1928 and 1930, respondent, Bankline Oil Company, operated a casinghead gasoline plant in Signal Hill Oil Field, Los Angeles County, California. On January 9th of that year it entered into a contract with General Petroleum Corporation [R.

107-115] by the terms of which it agreed to construct, within ninety (90) days, a casinghead gasoline plant in the Signal Hill oil district. When the plant was completed General Petroleum Corporation agreed to deliver to Bankline at the gas traps or casingheads all gas produced from wells operated by General Petroleum in the Signal Hill area. Bankline in turn agreed to treat the gas so received and to pay the General Petroleum a royalty of 33⅓ per cent of the gasoline extracted.

On October 25, 1923, respondent entered into three contracts with the United Oil Company on substantially the same terms. On May 22, 1925, it made a similar contract with the Superior Oil Company for the treament of its gasoline, and on October 29, 1928, one with the Richfield Oil Company for the same purpose. Each of the contracts called for the payment of a 33⅓ per cent royalty.

The gasoline delivered under the contracts last mentioned constituted a relatively small percentage of the products treated in respondent's plant. As will be seen by an examination of "Exhibit 8" [R. 118-120], over 75 per cent of all the gas treated in the plant was treated under respondent's contract with General Petroleum.

In accordance with the provisions of the contracts, respondent attached pipelines to the various wells, carried the gas from those wells to its plant, where the gas from the wells of the different operators was commingled, and removed the gasoline therefrom. The gasoline manufactured was sold, and respondent accounted to each producer for one-third of the proceeds of the producers' *pro rata* of the gasoline made. A large part of the dry gas remaining after the removal of the gasoline was blown into the air because there was no market for it. Some of the dry gas was sold to public utilities, in which case respondent

paid the producer for his *pro rata*, and some of the dry gas was returned for injection into the various wells that had been depleted by a long period of production. This injection was for the purpose of repressuring, and to cause wells, on which the pressure had declined, to continue to produce additional quantities of oil and gas.

It leads to a misconception to state that wet gas is never sold at the mouth of the well. It is true to say that it is not sold at so many cents per thousand feet. Invariably a gasoline absorption company is given the right to remove it, and, for that privilege, it pays the owner of the well a share of the gasoline recovered and a share of the dry gas residuum sold. [R. 121, 125, 133.]

During the years in question, the prevailing rate of royalty was considerably higher than the 33⅓ per cent which Bankline had agreed, in its contracts, to pay. In 1927 it was 45 per cent; in 1928, 47½ per cent; and by 1930 had increased to 50 per cent. There is no dispute about this fact, for it was testified to by respondent's witnesses, J. Lee Cross [R. 121], T. L. Taggart [R. 126], and John McFarland [R. 127], all of whom showed knowledge and familiarity with conditions. The conclusion was confirmed by Baxter, the only witness for petitioner. [R. 134.]

Therefore, if respondent's contentions are correct, it is entitled to an allowance for depletion computed in the following manner:

	Value of Gasoline Recovered	Contract Royalty	Prevailing Royalty	Depletable Interest	Depletion
1927	$626,494.68	$208,831.67	$281,922.61	$ 73,090.94	$20,100.00
1928	769,633.55	256,544.33	365,575.94	109,031.61	29,983.69
1930	390,596.48	130,257.68	195,298.24	65,040.56	17,886.15

The Commissioner determined deficiencies against respondent, and respondent appealed to the Board of Tax Appeals, contending that it was entitled to deduct, as percentage depletion, 27½ per cent of the difference between the price which it paid for the wet gas and its fair market value at the mouths of the wells.

As stated by petitioner in its brief, the Board of Tax Appeals held that under its contracts respondent acquired no depletable interest in the gas production. However, the Circuit Court of Appeals determined that the contracts were sufficient to give respondent an economic interest in the wet gas in place, and that it was entitled to an allowance for depletion. The Court remanded the case to the Board of Tax Appeals for the purpose of taking further testimony upon the question of the amount of depletion.

From that decision the Commissioner applied for certiorari.

Summary of Argument.

In order to establish a right to an allowance for depletion, a taxpayer need only show that he has a right to share in oil or gas as produced or, in other words, that he has an economic interest in the production. He need not show that he has technical legal title to the oil or gas in place.

The holder of a contract entitling him to all of the gas produced during the life of a certain well has such an interest. He is more than a mere purchaser of the gas after it is produced. If the contract calls for the payment of less than the prevailing royalty for the gas, he has an income from production upon which he is entitled to a deduction for depletion.

ARGUMENT.

I.

Respondent Had an Economic Interest in the Gas in Place.

It has long been recognized that the supply of oil and gas, like the supply of other natural resources, is not unlimited. Each time a barrel of oil or a thousand cubic feet of gas is removed from the earth, the future recovery from that particular property is reduced *pro tanto*. For that reason Congress, long since, has recognized that it would be improper to tax, as income, the whole amount of money received by those entitled to the products of oil wells. It has therefore provided that those who have an interest in oil and gas wells shall be entitled to an allowance for depletion.

See:

Revenue Act of 1926 (c. 27), 44 Stat. 9, Sec. 204 (c 1, 2), 234 (a 8);

Revenue Act of 1928 (c. 852), 45 Stat. 791, Sec. 23 (m 1), 114 (b 2, 3);

(Set forth in Appendix, pp. 19 to 22.)

The Government has almost continually, since its enactment, sought to limit this allowance for depletion to a very narrow class of persons. However, this Court has consistently refused to allow such limitations. In one of its relatively early income tax decisions, the Court determined that the depletion allowance was not confined to the actual operator of the well.

Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370.

Respondent was the lessee of a mine and had agreed to pay the owner a royalty. It subleased the mine to a third party, reserving to itself a royalty over and above that to be paid to the lessor. Upon the income received, respondent claimed an allowance for depletion. The Government contended that only the owner of the fee had a sufficient interest in the minerals to secure such an allowance. This Court refused to recognize the Government's contention and, in affirming the judgment in favor of respondent, said:

> "It is said that the depletion allowance applies to the physical exhaustion of the ore deposits, and since the title thereto is in the lessor, he alone is entitled to make the deduction. But the fallacy in the syllogism is plain. The deduction for depletion in the case of mines is a special application of the general rule of the statute allowing a deduction for exhaustion of property. *While respondent does not own the ore deposits, its right to mine and remove the ore and reduce it to possession and ownership is property within the meaning of the general provision.* Obviously, as the process goes on, this property interest of the lessee in the mines is lessened from year to year, as the owner's property interest in the same mines is likewise lessened. There is an exhaustion of property in the one case as in the other; and the extent of it, with the consequent deduction to be made, in each case, is to be arrived at in the same way; namely, by determining the aggregate amount of the depletion of the mines in which the several interests inhere, based upon the market value of the product, and allocating that amount in proportion to the interest of each, severally considered." (Italics ours.)

Subsequently the doctrine was extended by the case of

Palmer v. Bender, 287 U. S. 551, 557.

Petitioner was a member of two partnerships which had drilled for and discovered oil on property in Louisiana. Thereafter the partnerships assigned the lease in consideration of the payment of a certain sum in cash, a further payment of $1,000,000 to be paid out of one-half of the oil produced, and an additional one-eighth royalty. Petitioner claimed the right to take depletion upon the amounts paid to him out of oil, but the Commissioner contended that, inasmuch as the transactions constituted sales of the interests, petitioner had no interest in the production of the oil and was, therefore, not entitled to a depletion allowance.

This Court held that, although he was not technically a lessor, petitioner was entitled to an allowance for depletion upon the bonus and royalties received by him.

> "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital.
>
> "That the allowance for depletion is not made dependent upon the particular legal form of the taxpayer's interest in the property to be depleted was recognized by this Court in Lynch v. Alworth-Stephens Co., 267 U. S. 364; 69 L. Ed. 660, 45 S. Ct. 274. There a depletion allowance under Paragraph 12(a) of the 1916 Act, (September 8) 39 Stat. at L. 767, Chap. 463, was claimed by a lessee of a mining lease, in the computation of tax on income from the proceeds of ore mined. The statute made no specific

reference to lessees and the Government argued that as the lessee acquired no ownership of the ore until the severance from the soil (see United States v. Biwabik Min. Co., 247 U. S. 116, 123, 62 L. Ed. 1017, 1020, 38 S. Ct. 462), the lease gave him no depletable interest in the ore in place. But this Court held that regardless of the technical ownership of the ore before severance, the taxpayer, by his lease, had acquired legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease. Depletion was, therefore, allowed.

"Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. *It is enough, if by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.*" (Italics ours.)

See also, to the same effect:

Commissioner v. Williams, 82 Fed. (2d) 328, 329; C. C. A. 5.

"One has an economic interest in oil, in place, whether the interest he has retained is a right to share in the oil produced or a right to share in the proceeds of the sale of the oil produced."

***Thomas v. Perkins*, 301 U. S. 655;**

***Helvering v. Twin Bell Oil Synd.*, 293 U. S. 312;**

***Herring v. Commissioner*, 293 U. S. 322;**

***Helvering v. Falk*, 291 U. S. 183;**

United States v. Biwabik Mining Co., 247 U. S. 116;

Obispo Oil Co. v. Welch, 85 Fed. (2d) 860; C. C. A. 9;

Commissioner v. Elliott Petroleum Corp., 82 Fed. (2d) 193; C. C. A. 9;

Commissioner v. Fleming, 82 Fed. (2d) 324; C. C. A. 5.

We submit that the foregoing decisions of this Court compel a decision in favor of Bankline Oil Company. That Bankline acquired, by virtue of its contracts, a right to share in the gas produced must be clear.

As pointed out in the statement of facts, Bankline was given the right to all of the gas that was ever produced from the wells in question. It was obligated to install meters for the measurement of gas coming from each property [R. 112], and had the right, whenever necessary, to maintain vacuums on the wells for the purpose of assisting in the production of gas that would not otherwise be produced. [R. 110.] It was also obligated to return to the producer the dry gas remaining after the extraction of the gasoline. [R. 112.] This residual dry gas was used, in part, for injection into wells to increase their productivity after the pressure had declined. Such injection, known as the gas lift, results in an increased production of both oil and gas.

It may be noted that gas contracts of the type involved in the instant case bear no analogy to the purchase of oil by a refiner. Oil is either purchased on day to day arrangements or on short term contracts. Invariably they provide for payment at the posted price or at the market price. Furthermore, the oil may be transported by pipe-

line or otherwise and treated at remote refineries that can draw their raw materials from widely separated areas.

On the other hand, casinghead gasoline absorption plants must be situated in or close to the fields where the gas is produced. They become useless when the gas in that field is exhausted. The operator builds his plant in reliance on contracts that assure him of a supply of gas for the life of the field. He has, for a valuable consideration, to-wit, building a plant

> *"acquired legal control of a valuable economic interest."*
>
> *Palmer v. Bender, supra.*

The interest which respondent acquired in the gas to be produced out of the wells in question was an even greater interest than the one acquired by the taxpayer in *Palmer v. Bender, supra.* Palmer had only the right to receive a fixed sum of money. Unless the wells produced less than enough to pay him his $1,000,000.00, he had no interest in the ultimate amount of oil produced. His interest in production was, therefore, more or less nebulous and contingent.

Respondent, on the other hand, had a direct and vital interest in the ultimate recovery of gas from its wells. It had a right to share in the gas produced. Each day's production of gas reduced the amount it could expect to receive in the future. Consequently, as stated by the Circuit Court of Appeals in deciding the instant case, respondent

"had a definite economic interest in the oil (gas) in place, upon which it was entitled to an allowance for depletion."

Bankline Oil Company v. Commissioner, 90 Fed. (2d) 899; C. C. A. 9.

The same court had reached a similar decision in

Signal Gasoline Corporation v. Commissioner, 66 Fed. (2d) 886, 890; C. C. A. 9.

Signal was in the same business as is Bankline. The contracts which it had were substantially similar to those of respondent, and the Court held it had depletable interest, saying:

"Accordingly, the right to a depletion allowance does not depend upon the nature or character of the legal estate retained or acquired by the parties to an original oil and gas lease or their successors, but depends entirely upon whether any such parties are entitled to share in the oil and gas produced from the properties. If any of such parties are entitled to a share of the oil and gas, he had the 'economic interest' upon which the Supreme Court bases the right to a depletion allowance.

"Applying the principle as established by the Supreme Court, it seems clear that the interest of petitioner was included within the meaning of the statute, permitting deduction of a reasonable allowance for depletion, according to the peculiar conditions in this case."

The Commissioner took no appeal from that decision. In the hearing before the Circuit Court of Appeals in the instant case the Commissioner sought to point out alleged distinctions between the position of the Bankline Oil Com-

pany and that of the Signal Gasoline Corporation. However, the Court held that the contracts of the two corporations were substantially similar, and that both had an economic interest in the gas in place.

We therefore submit that by virtue of its contracts respondent acquired an economic interest in the gas to be thereafter produced and was entitled to an allowance for depletion.

II.

Comments on the Argument of Petitioner.

The argument advanced by petitioner is based upon a contention often repudiated by this Court. The petitioner claims that in order to establish a claim for depletion the taxpayer must show that title to the oil and gas in place is vested in him. This is not the law.

Thomas v. Perkins, 301 U. S. 655, 659.

> "We need not decide whether technical title to the oil while in the ground was in assignors, or assignees."

Palmer v. Bender, 287 U. S. 551, 557.

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. *It is enough, if by virtue of the leasing transaction, he has a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production.*" (Italics ours.)

Petitioner seems to be confusing ownership, as used in its technical legal sense, with the right to share in oil or gas produced.

We submit that, under its contracts with the owners of the wells, respondent acquired a right to share in the gas produced. As we have pointed out, this right to share in the gas as produced gives to the person who has that right an economic interest in the gas in place, and therefore a right to depletion.

Petitioner argues, however, that Bankline was merely in the position of a purchaser of wet gas after it was produced. We believe that an examination of its contracts [R. 76-115] will show that the interest conveyed to respondent was greater than a mere right of purchase. Respondent was given the exclusive right to *all gas produced* from the designated properties *as long as gas was available*. It was given the right to go to the wells and remove the gas. It also had the right to create vacuums to increase the flow of gas. By agreeing to convey such rights, the operator of the well is in reality surrendering all interest he may have in the gas except the royalty he reserves.

Such agreements place respondent in a position very similar to that of a sublessee under an oil lease. The sublessee, in consideration of the payment by him of a certain fixed royalty, is given the right to the oil and gas produced from a designated property. Similarly respondent, in consideration of the payment by it of a fixed royalty, is given the right to all gas produced from designated wells. The grant of such a right constitutes far more than an agreement of sale. It gives respondent the right to share in the gas as produced.

Even if respondent was in the position of a purchaser of gas, it would still have an economic interest in the ultimate production in view of the nature of its contracts, which entitle it to *all* of the gas produced from the various

wells. Its interest is certainly far more direct and more closely connected with the ultimate production than was the interest of the taxpayer in *Palmer v. Bender, supra,* and in other cases decided upon the principle there established. As we have already pointed out in the preceding portion of this brief, a person who was entitled to a fixed sum of money, payable out of oil, is not actually interested in the ultimate production from the property. On the other hand, a man who has built a plant for the sole purpose of treating the products coming from that well has as great an interest in the production as the person who has drilled the well, or who receives a royalty.

The next contention of petitioner is that there can be no right to depletion because the right disappears the moment that the prevailing market price of the gas drops to, or below, the price stipulated in the contract. In raising that point we believe that the petitioner has misconceived the contention of the respondent and the opinion of the Circuit Court of Appeals. He is confusing the right to a depletion allowance with the amount of the allowance.

It is our contention that Bankline Oil Company has, by virtue of its contracts, an economic interest in the gas in place in the well and therefore has a depletable interest, regardless of relative prices. However, only when the prevailing royalties, established in the open market, are above the royalties stipulated in the contract does respondent receive an income from production upon which to compute its depletion allowance.

If, by virtue of its contracts, respondent is required to pay the prevailing royalty for the gas which it removes from the wells, it has no gross income from production upon which to base its 27½ per cent depletion allowance.

It is in the same position as the man who has drilled an unproductive oil well—he has a right to depletion but no income on which to take it. Only when the prevailing royalty for gas is above the amount respondent is required to pay, does respondent receive income from the production of gas. Only then has it established a basis upon which to compute a depletion allowance.

Conclusion.

The respondent has established that it has a right to share in the oil produced. It therefore stands in the same position as others whom this Court has determined have a right to depletion.

The Circuit Court of Appeals, though reversing the judgment of the Board of Tax Appeals, refused to determine the amount of depletion to which respondent was entitled on the ground that that was a matter of fact on which the Board should make a finding.

We respectfully submit that this Court should affirm that judgment of the Circuit Court of Appeals, and remand the case to the Board of Tax Appeals to find the amount of depletion to which respondent is entitled.

Dated, Los Angeles, California, January 31, 1938.

Respectfully submitted,

A. L. WEIL,

Counsel for Respondent.

MARTIN J. WEIL,

Of Counsel.

APPENDIX.

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and absolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

(c) (1) In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(c) (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (Computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * * * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(1) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such rea-

sonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion in case of oil and gas wells, see section 114 (b) (3).)

(m) Basis for depreciation and depletion.—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) Basis for depreciation.—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property.

(b) (2) *Discovery Value in Case of Mines.*—In the case of mines discovered by the taxpayer after February 28, 1913, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter, if such mines were not acquired as the result of purchase of a proven tract or lease, and if the fair market value of the property is materially disproportionate to the cost. The depletion allowance based on discovery value provided in this paragraph shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. Discoveries shall include minerals in commercial quantities

contained within a vein or deposit discovered in an existing mine or mining tract by the taxpayer after February 28, 1913, if the vein or deposit thus discovered was not merely the uninterrupted extension of a continuing commercial vein or deposit already known to exist, and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

(b) (3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.